

# **UNDERWRITING GUIDELINES & FINANCING POLICY**

*As of November 22, 2002*

## **Assisted Living Underwriting Guidelines For Construction and Permanent or Permanent Only Loans**

### ***ELIGIBILITY:***

#### **Eligible Projects**

The developer must obtain a resolution from the municipality in which the project will be located reciting that there is a need for their particular housing project in that municipality. A Certificate of Need from the Department of Health and Senior Services (DHSS) must be received with the application for financing. Developers should be cognizant of the New Jersey State Development and Redevelopment Plan and understand that as a rule, the HMFA will only finance projects if they fit within that plan. If your development is located in the area of four or five, you may need special approval from the State.

#### **Tax Abatement**

The developer should obtain a municipal resolution granting a real estate tax abatement and authorizing an agreement for payments in lieu of taxes ("P.I.L.O.T") for the project under the HMFA's statute, N.J.S.A. 55:14K-37, during the mortgage term. Furthermore it is beneficial to the project if a tax abatement is pursuant to the HMFA's statute rather than the Long Term Tax Exemption Statute.

In general the HMFA has found that a project without tax abatement or a project with tax abatement under the Long Term Tax Exemption statute have trouble demonstrating financial feasibility. Lack of a tax abatement pursuant to the HMFA's statute may increase the risk to the HMFA and therefore may require additional security in the form of increased debt service coverage or the escrow of additional funds.

#### **Development Team**

The development team, which includes the developer, operator (or Health Care Consultant), architect, general contractor, and marketing agent must provide evidence of relevant experience.

If the Operator is a newly formed company, it must display, at minimum, one (1) full year of operating a similar type facility and, the principals of the company, must display at a minimum, five (5) years experience in a related field.

This experience must be in all areas of marketing and operations. Should an operator also wish to be the developer, likewise that entity must display development experience or, have an experienced consultant that can provide them with the necessary guidance to develop and build the project.

An “Operator” is defined as the company that operates the facility and is responsible for all services and care provided to the residents. The Operator may or, may not have asset management responsibility but, if it does not, the asset managing entity must rely on the Operator’s fiscal decisions where the welfare and well-being of the resident is concerned.

An Operator must play a role in the pre-development, construction and pre-marketing periods. At the time of application, the developer must have a Letter of Intent from an HMFA approved Operator. Prior to closing, the developer must have entered into a contract with the operator for a minimum of five (5) years commencing at construction completion. Specialized wings, or projects such as Alzheimers, require specialized experience. A developer without five years of experience in assisted living and or the specialty may not operate the Assisted Living Residence.

Pre-development responsibilities of the Operator/consultant include but are not limited to assistance with: budget, setting fees, working with the architect to develop good traffic patterns and work conditions, etc.

As a condition of the mortgage commitment, all assisted living developers will have had to enter into a five-year contract with the Operator that was approved by the HMFA. Additionally, once the HMFA has issued a commitment to fund a specific project with an HMFA approved operator, the developer may not change operators without expressed permission of the HMFA.

### **Maximum Loan Amount**

The maximum loan for New Construction or Rehabilitation may not exceed 75% of replacement costs minus the land value as determined by the third party appraisal ordered by the HMFA. In all instances, both for-profit and non-profit developers may not borrow more than the statutory requirement of 90 and 100 percent of total project costs respectively.

If a developer can show the project can sustain a set aside of an additional 20 percent of its units for either low- or moderate-income residents over its obligation of affordable units, thereby sustaining a minimum total of 40% affordable units in the case of the required 20% at 50% of area median income, or 60% affordable units in the case of the required 40% at 60% of area median income, the requirement of a maximum loan of 75% of replaceable costs will be waived and the for-profit entity will need only meet the 90% of total project costs or actual appraised value at stabilization, whichever is less. Non-profits will be permitted to borrow up to 100% of the lesser of appraised value at stabilization or the total project costs if they can show they can show the same or greater 40% affordability.

### **Risk Analysis**

All Assisted Living Residences must be credit enhanced for the term of the first mortgage. Credit enhancement may be provided through letters of credit, the HUD Risk Sharing Program or other forms acceptable to the HMFA. If HUD Risk Share is used and the set aside units are less than 40% affordable to low- and moderate-income residents, a 10% risk will be assumed by the HMFA. If 40% or greater of the units are set aside as affordable, the HMFA will consider taking a higher (25%) share of the risk. If HUD Risk Share is used, it must be approved prior to the HMFA Board Approval.

Any request for mortgage terms in excess of 30 years must be supported by the provision of credit enhancement. The HMFA will perform a risk assessment on each loan application. Projects may be subject to additional credit enhancement obligations based upon the HMFA's assessment.

### **Preliminary Market Study**

All loan applications for HMFA financing must be accompanied by a preliminary market study. The preliminary study must be performed within one year of the application date, completed in accordance with HMFA Market Study Standards and Procedures for Assisted Living Residences and be certified to the Agency. The study will include a description of the project, market area competition, the demographic characteristics of the Primary Market Area, the supply and demand factors and a detailed analysis indicating how the proposed facility will meet the needs of the target group. See "A Guide to Financing Assisted Living and Opening the Doors to A New Millennium" for these standards.

### **Operator Questionnaire**

The Operator Questionnaire must be submitted at the time of

application. The Operator, through the completion of the Operator Questionnaire, must include their business and marketing plans, which outline their proposed activities, staff ratios, room rates for rent, food and services, and referral sources.

The questionnaires will be reviewed for completeness and the information contained within will be reviewed to ascertain the operator's ability and acceptability. The provider must be approved by the HMFA to operate the facility. See "A Guide to Assisted Living and Opening the Doors to a New Millennium" for further information.

## **Marketing Plan**

For all projects receiving an HMFA commitment, the sponsor and/or the managing agent must provide a marketing plan for the HMFA's approval and acceptance. This plan must outline all the preliminary marketing to be accomplished prior to opening and thereafter. The plan must also provide for the on-going marketing efforts that will be made to keep the project fully occupied. The outline must provide a time line for all anticipated activities and should be tied to benchmarks during construction.

Where the HMFA is making both the construction and permanent loan, the plan must be submitted prior to closing on the construction loan. Where the HMFA is providing only the take-out financing, the project must submit its marketing plan prior to construction start. In certain cases of rehabilitation where there is an existing occupancy, the sponsor and/or the operator should submit documentation that a full marketing plan is not needed and give the reasons the HMFA should accept a lesser marketing outline.

## ***LOAN TERMS:***

### **Debt Service Coverage Ratio**

The debt service coverage ratio is the relative cash flow available to meet the annual interest, principal, and HMFA servicing fee payments on debt. The project must achieve and maintain a minimum of 1.40 debt service coverage ratio for a 15 year period. Debt Service Coverage Ratio calculation is as follows:

$$\frac{\text{Net Operating Income}}{\text{HMFA Debt Service} + \text{Serv. Fee}} = \text{Debt Service Coverage Ratio}$$

- See Typical HMFA Fees and Transactions section.

### **Term**

Standard term is 30 years. Developers may request a shorter

or longer term. Longer terms are subject to HMFA Risk Analysis policy.

**Lien Status**

All loans will be secured by a first mortgage on the land and improvements. If the property is owned subject to a ground lease, the HMFA will require a leasehold mortgage secured by the lease and the improvements; however, the term of the ground lease must at a minimum be for the term of and subordinate to the first mortgage, subject to the HMFA Deed Restriction, and be in all respects satisfactory to the HMFA.

**Secondary Financing**

The HMFA will permit secondary financing. This financing may be in the form of an amortizing loan provided the project is able to maintain a minimum of a 1.40 debt service coverage ratio including the secondary financing. In no event may the secondary lender institute foreclosure proceedings without the consent of the HMFA.

**Security/Collateral**

HMFA loans are secured or collateralized by a lien on the land, improvements, project revenues, equipment, furnishings and escrows. There is generally no recourse to other assets of the borrower except in the case of fraud or other unlawful acts with regard to the project.

**Mortgage Interest Rate**

The mortgage interest rate is a fixed rate for the term of the mortgage and will be determined based upon the HMFA's actual cost of funds and allowable spread at the earlier of the loan closing or bond sale. For current rates visit the Multifamily Programs Interest Rate section of HMFA's web site.

**Rate Lock**

The rate is locked one week prior to the pricing of bonds that will fund the loan and will be fixed for the term of the loan. Developers are responsible for the interest rate risk prior to that period as the positive or negative change in the interest rate will have the effect of increasing or decreasing the mortgage that the project can support and remain in compliance with the HMFA's Underwriting criteria.

**Commitment Term**

Construction and permanent loan commitments will expire 90 days after the anticipated construction start date. In the case of permanent only loans, the commitment will expire 90 days after the assisted living project reaches sustaining occupancy.

For this purpose, sustaining occupancy is defined as: the point in time when the facility can sustain all of its expenses including operations, escrows and reserves, debt service. The Executive Director may extend this period for two 90-day terms. A written request for extensions must be made to the Agency and are subject to its approval.. Commitment extensions should not be considered automatic and may have new terms and conditions added.

Once a commitment and all extensions have been exhausted, the developer must request a new commitment. Any issuance of a new commitment will be under the terms and conditions of the existing underwriting guidelines and will be treated as a new loan application.

**Fees**

See Typical HMFA Fees and Transactions section.

**UNDERWRITING ANALYSIS**

*See Developer s Guide for processing steps and pro forma/form 10 instruction sheet for more detailed information.*

**Site Acceptance**

The HMFA will visit the site to determine that the site is suitable for the development purpose.

**Real Estate Valuation**

The HMFA recognizes the lesser of the appraised value or the purchase price of the realty and any buildings and improvements thereon, in the most recent arm's length transaction as provided by a "Delineation of Title" history identifying each party associated with the conveyance for a minimum of 10 years or three transactions. The total purchase price may include documented carrying costs, expenditures to obtain zoning, environmental or other governmental approvals necessary or useful for the development of the project, and the costs of improvements erected for the benefit of the project. The difference between the actual purchase price and the appraised value, if the total purchase price is higher, may be recognized for the purposes of Return on Investment.

## **Appraisals\***

An independent appraisal will be commissioned by the HMFA to determine value of the site, building and business. The appraisal will be performed in accordance with HMFA Appraisal Standards and Procedures for Assisted Living Residences. The value of the federal Low-income Housing Tax Credits must be submitted provided a positive Private Letter Ruling has been obtained from the IRS and has been accepted by the HMFA.

An appraisal may be up-dated no more than twice at which time it may be necessary to order a new appraisal. In no case, should an appraisal be more than six months old at the time of closing. It should further be understood that any increase or decrease in value as well as the supply and demand factors would be taken into consideration at the time of commitment extensions or re-commitment.

Appraisal Standards and Procedures for Assisted Living Residences can be found in A Guide To Financing Assisted Living Residences And Opening the Doors to a New Millennium or, are available upon request. Also, see Typical HMFA Fees and Transactions section.

## **Market Study\***

A market analysis is generally included in the appraisal. It may also be necessary to up-date the preliminary market study or require a more detailed market study in the appraisal to determine supply and demand, the overall vacancy rates, absorption periods, penetration rates, rental comparables, marketing plan and budget. The market analyst must certify his/her findings to the HMFA. HMFA Market Study Standards can be found in “A Guide to Financing Assisted Living Residences and Opening the Doors to a New Millennium”. Also, see Typical HMFA Fees and Transactions section.)

\* If at the time of bond sale or recommitment the appraisal and/or market study report are more than 6 months old, an update will be ordered. The reports should demonstrate, to the satisfaction of the HMFA, that the appraised value of the project still meets the HMFA’s underwriting requirements and that the rent-up and/or operational feasibility of the project has not been jeopardized. If the up-dated appraisal and/or market study demonstrates that the appraised value is reduced or the rent-up and/or operational feasibility of the project has been jeopardized, the HMFA is not required to extend the mortgage commitment, include the project in its bond sale and/or make the permanent loan. If the HMFA extends the mortgage commitment and/or includes the project

in its bond sale, the HMFA may adjust the amount of the mortgage loan and any other terms of its commitment, as it deems necessary to address changes arising from the updated appraisal and/or market study.

**Saturation Rate**

Saturation Rate =  $\frac{\text{Total of the project beds} + \text{the competition}}{\text{Qualified Population}}$ .

**The Saturation rate should not exceed 30% to 35%.**

**Penetration Rate**

Penetration Rate =  $\frac{\text{Qualified Population}}{\text{\# of Project Beds}}$

**The maximum penetration rate should not exceed 20%.**

**Vacancy Rate**

Throughout the underwriting process, the HMFA will use a vacancy rate reflecting the conditions currently existing at the time of underwriting both within the state and nationally. As of July 1, 2002, this rate is 15%. Once the appraisal is received, the HMFA will also take the appraiser's findings into consideration but is not obligated to use it.

**Absorption Rate**

For application purposes and with regard to an HMFA construction and permanent mortgage only, the HMFA anticipates a first months initial occupancy of 5 units/beds and 3 units/beds per month thereafter. Once the Appraisal/Market Study has been received, its findings will be taken into consideration when determining the final absorption rate. However the rate will be determined based on all data the HMFA has at its disposal including portfolio data, site specific, state and national data to determine its rate of absorption.

With regard to underwriting a permanent only loan, the HMFA will be less concerned with the absorption rate since it will be taking the loan out at sustaining occupancy.

**Expense to Income Ratio**

Expense to Income =  $\frac{\text{Total Expenses in the 1}^{\text{st}} \text{ stabilized year}}{\text{Total Income in that same year}}$

**Minimum of 60% to 65% in first full, stabilized year of operations.**

**Building Design**

The HMFA does not allow the use of EIFS (Exterior Insulation Finish Systems) such as Dryvit. Developers must endeavor to make developments as energy efficient as possible by meeting the standards established in DfE/EPA's Energy Star Program.

The building must be designed in a way that permits the common areas to be interspersed throughout the facility, thus dividing the residential areas into smaller more home-like settings. This also eliminates long hallways, which give the



facility an institutional feel, and, of more importance, is sensitive to the frail individual's inability to walk for long distances and periods of time. Hallways can be no more than 75 feet in length from a resting area and include handrails on both sides of the walls.

**Minimum unit sizes:**

Efficiency/Studio Units – minimum of 425 sq. ft.

One-Bedroom Units – minimum of 525 sq. ft.

Two-Bedroom Units – minimum of 625 sq. ft.

**The HMFA will not finance Assisted Living Residences with more than 100 beds.** See “A Guide to Financing Assisted Living and Opening the Doors to a New Millennium” for further guidance.

Shared units will only be underwritten with one bed filled. All bedrooms must be large enough to hold a double bed comfortably. The minimum area required for any bedroom is 120 square feet.

Finally, the HMFA Technical Services Division will review all plans and specifications design standards and cost appropriateness. All required plans and specifications must be submitted to the HMFA for this review. Any changes to drawings must also be submitted and approved by the HMFA. This should begin with the early stages of drawings and continue even during plan submission to the Department of Community Affairs for approval. **NOTE:** A structural engineering report, acceptable to the HMFA, must be submitted for rehabilitation projects. See “A Guide to Financing Assisted Living and Opening the Doors to a New Millennium” for further guidance.

**Construction & Permanent Financing**

Where the HMFA provides both the Construction and Permanent Financing, a 100% payment and performance bond is required, for a term of two years from the date of issuance of the Certificate of Occupancy (CO) or Architect's Certification of Substantial Completion, whichever is the later. All bonding companies must be rated with an A.M. Best Rating of B+ or better.

**Construction Budget**

The construction budget must be supported by a Summary Trade Break Payment Breakdown signed by the contractor. This document and other supporting schedules such as the construction completion schedule and design development drawings must be submitted by the contractor and approved by the Director of Technical Services. Refer to “A Guide to Financing Assisted Living and Opening the Doors to a New Millennium” for the timing of the submission of these documents.

**Wage Rates**

For construction financing, the contractor and subcontractors must pay prevailing wages as determined by the N.J. Department of Labor except that prevailing wages determined by the U. S. Department of Labor under the Davis Bacon Act shall be used if the HMFA construction loan is subject to direct or indirect federal assistance.

**Sales Tax Exemption**

Sales of materials or supplies to housing sponsors utilizing HMFA construction financing are exempt from NJ State sales tax. Sales of materials or supplies to contractors for the purpose of erecting housing projects which have received HMFA construction financing and other local, state or federal subsidies are exempt from NJ State sales tax.

**Construction Draws**

With regard to construction draws, the borrower will be required to fund a proportionate share of each draw request equal to the percent of equity reflected in the closing form 10, except in the initial draw, and only if the borrower is due reimbursement for a proportionate share of pre-closing costs.

In no event will the HMFA provide greater than 80% of a draw.

**Affirmative Housing Marketing Plan**

This plan must be designed to show how the operator intends to reach those persons who are least likely to apply for entry into the Assisted Living Residence. It must be completed and approved at least 9 months prior to construction completion. If the project involves rehabilitation and residents living in the facility, the Affirmative Housing Marketing Plan must be completed and approved prior to commitment.

The affirmative marketing plan should not be confused with the “Marketing Plan” referred to under “Eligibility” which is required as a part of the Operator Questionnaire.

**Permanent Financing\***

Where HMFA construction financing is not used, the HMFA will take-out the construction lender only after the assisted living project has reached sustaining occupancy. For this purpose, sustaining occupancy is defined as: the point in time

when the facility can sustain **all** of its expenses including operations, escrows, reserves and debt service for three consecutive months. In addition, the developer must provide one of the following, for two years from the date of issuance of the Certificate of Occupancy (CO) or Architect's Certification of Substantial completion, whichever is the later:

- 100% Payment and Performance Bond equal to construction cost
- Letter of Credit equal to 10% of the construction cost
- Warranty Bond equal to 30% of construction cost

**\* All insurance must be issued by a firm with an A.M. Best Rating of B+ or better.**

### **Operating Budget**

The operating budget portion of the pro forma must be completed by the Operator and independently from the sponsor. It must provide the number of full time equivalent (FTE) employees, the month they are anticipated to begin work and their anticipated salaries. Monthly fees should be set by the Operator and shown on the pro forma in the categories of Rent, Food and Services by unit type.

### **Ancillary Income**

HMFA will recognize ancillary income equal to 1% of gross income from the monthly fee (which consists of costs for rent, meals and basic services) if adequately supported by market or other data. Ancillary income may include revenues from beauty shop, sundries store, staff meals, etc. Acuity Income (levels of care) are not considered Ancillary Income.

### **Acuity Income**

If Acuity Income (levels of care) is being used when projecting income to the project; a separate addendum to the pro forma (Form 10) should be used to show the different levels of care and, additional costs for it. When the Operator is using this type of pricing, rationale should be given as to the number of persons projected for each level of care being projected.

### **Contingency**

The budgeted contingency for new construction projects is 5% of the construction costs. The contingency may be used to cover increases in both hard and soft costs. When rehabilitation work is being done, the contingency will be 10% of the construction costs. This may be adjusted up or down based upon an acceptable engineering report submitted to the HMFA.

## **Environmental Review**

A Preliminary Assessment Report as described in N.J.A.C. 7:26E-3.2 is required. Additional assessments, such as a Site Investigation described in N.J.A.C. 7:26E-3.3 et seq., or DEP environmental remediation measures may also be warranted. Rehabilitation projects must provide a plan for asbestos removal and remediation of lead-based paint and radon. A letter of "no further action" from DEP may be required.

A transaction update from the consultant, indicating that no further pollutants have been introduced to the site, will be required on all assessments or investigations prepared more than **six months prior to construction start**. (See Typical Fee section)

## **Medicaid Income:**

All loans will be underwritten as though 10% of the units in a project will be funded using the Medicaid Waiver payment. This is effective for all applications received after April 30, 2002. The HMFA recognizes that there are currently no waivers available but must be prudent in its underwriting to be certain that when they do become available, the project can be sustained by the most conservative income estimation.

## ***OTHER LOAN REQUIREMENTS***

### **Professional Liability Insurance\***

#### **Contractor:**

- General liability
- Workmen's compensation
- Contractor's public liability in the sum of \$1,000,000/\$3,000,000 and property insurance of \$250,000/\$500,000

#### **Architect:**

- Architects must have Errors & Omission Insurance of 10% of the construction costs or, \$250,000 whichever is greater.

\* A firm with an A.M. Best Rating of B+ or better must issue all Insurance.

## **Developer's Fee**

The amount of the Developer's fee allowed is limited to 15% of the total development cost excluding land and if applicable building, working capital, marketing expenses, escrows, and operating deficit reserves. In addition, if the property is being acquired, the developer's fee may include an additional 5% of the related acquisition costs of the building only.

The following fees may be recognized on the pro forma in

addition to the Developer fee: the architect, engineer, lawyer, accountant, surveyor, appraiser, professional planner, historical consultant, health care consultant and environmental consultant. Financial consultants must be paid out of the developer's fee and may not be added as an additional charge on the pro forma.

If the HMFA is financing the construction and permanent mortgage loan, up to one-half of the un-pledged or un-deferred developer's fee will be retained in escrow until the assisted living project reaches stabilized occupancy and reaches a 1.40 debt service coverage. For these purposes, stabilized occupancy is defined as: the point in time when the facility can sustain **all** of its expenses including operations, escrows and reserves, debt service and can meet its debt service coverage ratio as required in its mortgage commitment. Developer's may pledge or defer the remaining portion of their developer fee to the project as equity. The amount allowable will be determined by the HMFA. The developer's fee is earned on a pro-rata basis during the construction period based upon the percentage of construction completion. The un-pledged portion of the developer's fee is payable only when earned and is earned only after the entire pledged portion has been earned.

## **Escrow Requirements**

Escrows must be funded from the capital budget at the time of closing on the construction and/or permanent loan and must remain in place for the term of the mortgage.

**\*Insurance Escrow** - one-half year's premium

**Mortgage Insurance Escrow** – one year's premium plus one-quarter of the following year's premium

**Other Credit Enhancements** - as per program requirements.

**\*Tax Escrow** - one-quarter of taxes - this may be on real property and/or a payment in lieu of taxes.

**Debt Service Escrow** - one-month's principal, interest and servicing fee payment.

**Operating Reserve** - one-day operating expenses, including the debt service, as determined by the HMFA.

\* Additional escrows may be required at closing for the HMFA to make the next payment or renewal.

**Working Capital**

Working capital is funded at construction loan closing or, at the time of the permanent financing only. The funds are generally used to cover necessary operating expenses after the project has received its license, debt service and HMFA fees until the project reaches a sustaining occupancy for a period of one full year. This deposit may be in the form of cash or letter of credit (LOC). This figure is based upon the Agency approved operating expenses and anticipated absorption rate. The Agency may use the appraisal/market study, industry standards, and/or other criteria as it sees fit, to determine the working capital amount. Working capital will not be released to cover cost expended prior to the receipt of the facility license or, necessary for the facility license. Any remaining working capital may be used to fund the operating reserve. See the section in this guide entitled "General Information" for the complete Working Capital Policy.

**Management Fee**

HMFA will look at the fee charged for the management of the project on a case by case basis; at no time will the management fee exceed 6% rents collected.

**Reserves, Repairs & Replacements**

\$600 per unit should be budgeted for the repair and replacement reserve in the first year of operations, subject to adjustment, and determined by the HMFA in subsequent years. This reserve covers the costs of repair and replacement of all major items and systems associated with a typical multifamily project and the costs for the additional furniture, fixtures and equipment required for an Assisted Living project.

**Furniture, Fixtures & Equipment**

A minimum start-up of \$4,200 per unit will be budgeted for all Assisted Living Projects.

**Operating Reserves**

Funded at closing with one day's operating expenses, including the expenses of tenant services and meals, and deposits are to be made gradually building up and equal to 75 days' worth of operating expenses before a return on investment is payable to the owner. This reserve may be set-up in one of two ways: 1) through cash deposits or 2) through the use of a LOC in the form acceptable to HMFA. If an LOC is used, it must be renewed as needed in order to remain in effect for the life of the loan.

**Income Targeting**

Projects using HMFA financing must set aside a portion of the proposed number of units for Low- and Moderate-income tenants.

**Restrictions on Set-aside Requirements:**

- 20% of the units must be occupied by persons at or below 50% of the applicable Area Median Income (AMI) or,
- 40% of the units must be occupied by persons at or below 60% of AMI
- All projects are required to participate in the Medicaid Waiver program and reserve a minimum of 5% of the income restricted units for persons who are eligible for that program. HMFA will accept the Medicaid eligibility criteria as meeting its low- or moderate-income requirement.

**Restrictions on Market Rate Units:**

- There are no restrictions on monthly fees except that at initial occupancy, the gross aggregate family income of the tenants in each unit (including, but not limited to, market rate units) may not exceed six times the annual rent or carrying charges, including the value or cost to them of heat, light, water, sewer, parking facilities, and cooking fuel.
- All market rate units will be re-certified income eligible every three years.

All restrictions on tenant income and on monthly fees shall be enforced through a deed restriction on the development and land for the term of the HMFA's mortgage. Developments receiving tax credits shall also be subject to a deed restriction pursuant to the IRS Code.

**Tax Credits**

Developers wishing to use federal Low Income Housing Tax Credits must follow the guidelines in the Low-Income Housing Tax Credit Qualified Allocation Plan and provide a Private Letter Ruling (PLR) from the IRS indicating the development is acceptable under Section 42.

**Rents**

Set-aside unit rents, including utilities, may not exceed 30% of the income for the targeted income selection. Market rate units are not restricted.

**Monthly Resident Fees**

For the set-aside units, charges for rent, food and certain basic services are covered in the monthly fee and are capped at 80% of the applicable Median Income. Family members may provide financial assistance where needed for those services outside the basic services provided. For a list of Basic Services, see "A Guide to Assisted Living and Opening the

Doors to a New Millennium”.

The monthly fees for food, rent and services on the market-rate units are not capped. Monthly fees charged for Medicaid recipients follow Medicaid restrictions.

**Determination of  
Development Cost**

Subject to the maximum loan amounts discussed under “Eligibility” above. The HMFA may finance project costs as determined by HMFA and as defined in NJHA 55:14K-3q. The HMFA will require the Developer to submit an audit of the project’s costs.

**Return on Investment**

Developers are entitled to a return on investment when the following benchmarks have been met:

- 1) two consecutive years of sustaining occupancy,
- 2) all reserve accounts, including the 75 day operating reserve fund, fully funded,
- 3) surplus cash flow.

Please refer to HMFA regulation N.J.A.C. 5:80-3 for the rates of return available to developers. 10% of payments made to the owner from project operating revenue, as return on investment, must be deposited into a Service Subsidy Fund. The Service Subsidy Fund will be used to help subsidize those low-income individuals who may run out of assets, are still suitable for Assisted Living care and, are not eligible for Medicaid. The fund is non-project specific.

**Sale or Prepayment**

The HMFA prohibits the sale of the project without prior Agency approval. If the project's mortgage term exceeds 20 years, it may be prepaid at year 20; however, the low-income housing and other HMFA restrictions remain in place through the original mortgage term pursuant to N.J.S.A. 5:80-3.10.

**Marketing Expenses**

The HMFA requires that a minimum of \$3,500 per unit be budgeted for pre-marketing expenses (prior to the receipt of a Certificate of Occupancy and License) and marketing during rent-up. That amount must be placed in escrow at the time of closing of the loan. The escrow may be financed provided the maximum loan amount is not exceeded.

**Cost of Certificate of Need**

The Department of Health and Senior Services application fee may be financed in the HMFA mortgage provided the maximum loan amount is not exceeded.

**Preliminary Marketing  
and/or Feasibility Study**

May be financed in the HMFA mortgage provided the



maximum loan amount is not exceeded.

**Health Care Consultant**

May be financed in the HMFA mortgage provided the maximum loan amount is not exceeded.

## TYPICAL HMFA FEES AND COSTS ASSOCIATED WITH THE TRANSACTION

### ***Application Fee***

Developers will be responsible for payment of a non-refundable application fee of \$2,500 due at the time of the initial application.

### ***Commitment Fee***

Where the HMFA is providing both the construction and permanent loan; the Developer will be required to pay a commitment fee in an amount equal to one (1) percent of the estimated mortgage amount projected at mortgage commitment.. This fee may be paid in cash or posting an unconditional and irrevocable letter of credit acceptable to the HMFA. The fee is due along with a signed commitment by the sponsor 15 days from the date the sponsor has been notified that we have taken the project to the HMFA Board for Action.

The commitment fee is refundable at the later of the issuance of bonds or mortgage closing. In the event that the project does not proceed to mortgage and/or bond closing, the fee shall not be refunded.

Where the HMFA will be taking-out the construction lender and providing the permanent mortgage loan only, the Developer will be required to pay a commitment fee in an amount equal to two (2) percent of the estimated mortgage amount projected at time of mortgage commitment. This fee may be paid in cash or posting an unconditional and irrevocable letter of credit acceptable to the HMFA. The fee is due along with a signed commitment by the sponsor 15 days from issuance.

### ***Re-Commitment.***

#### ***Fee (non-refundable)***

A \$2,500 re-commitment fee will be charged. This fee is due prior to the Board issuance of a re-commitment.

### **Pass Through Costs**

The HMFA will order the appraisal, market study, and environmental assessments. The costs for the aforementioned will be passed through to the developer.

### ***Cost of Bond Issuance***

The cost of issuance is the Developer's allocable portion of the costs incurred by the HMFA for the issuance of bonds which include, but are not limited to, underwriter's fee, bond counsel fees, rating agency fees, printing costs, trustee and trustee's counsel fees, bond insurance premiums, and auditors' fees. The cost of issuance is included in the mortgage interest rate.

The costs associated with the issuance vary dependent upon the overall size of the bond issue and will be allocated based upon the percentage each participating loan represents to the total bonds issued.

Developers may reduce the interest rate by paying the cost of issuance out-of-pocket, which is presently anticipated to result in an approximate 15-basis point-reduction in rate. This election must be made two weeks prior to the date of the bond pricing. The payment of it must be made one week prior to bond pricing.

***Negative Arbitrage  
Escrow***

A negative arbitrage escrow will be created which represents the difference between the rate the HMFA pays on the bond and the rate realized by the HMFA on the investment of the bond proceeds. The payment of same must be made one week prior to bond pricing.

***Construction Servicing  
Fee***

A 50 basis points servicing fee on the principal loan amount must be budgeted. This fee is incurred and billed monthly in equal installments throughout the anticipated construction term and is based on the original note amount.

***Annual  
Servicing Fees***

On all amortized debt, the HMFA servicing fee which is based on the original note amount shall be, at the option of the sponsor, either (a) zero points at closing and an annual fee of 65 basis points (55 basis points for projects paying 2% tax credit allocation fee) or (b) 2 points at loan closing and an annual fee of 50 basis points (40 basis points for projects paying the 2% tax credit allocation fee).

***For additional information regarding underwriting guidelines, please consult the Instruction Sheet for Completing the HMFA Form 10 pro forma***

# **SUPPLEMENTAL GUIDELINES FOR NEW JERSEY HOUSING AND MORTGAGE FINANCE AGENCY's ASSISTED LIVING UNDERWRITING GUIDELINES**

This guidance is extracted from HUD Notice H 97-01, Issues Related to Licensors, Underwriting and Development Processing of Board and Care Homes and Assisted Living Facilities and is for use in Assisted Living Projects to be insured under the Section 542(c) Risk Sharing.

## **I. PURPOSE**

These guidelines supplement and augment the New Jersey Housing and Mortgage Finance Agency's underwriting procedures. These guidelines provide specific guidance regarding definition, licensing, underwriting standards, marketing and monitoring projects insured under Level II participation of the Section 542(c) Risk Sharing Agreement between the New Jersey Housing and Mortgage Finance Agency and HUD. Application of these procedures is required for all such Level II mortgages for Assisted Living or Board and Care type facilities.

## **II. APPLICABILITY**

These instructions apply to mortgages for Assisted Living Facilities (ALFs) insured Section 542(c) of the Housing and Community Development Act of 1992.

## **III. BACKGROUND**

These guidelines are derived from HUD underwriting practices and guidelines which were written to address issues by the General Accounting Office in their review of such facilities. These guidelines discuss underwriting and development issues associated with Assisted Living Facilities (ALF) type projects. The GAO report "Greater Oversight Needed of FHA's Nursing Home Insurance Program (GAO/RCE-95-214)," dated August 1995, expressed concern that market-driven ALF and B&C mortgages were subject to special risks and required special considerations in underwriting. **The report shows that projects most often defaulted because they failed to achieve sustaining occupancy as quickly as projected or as underwritten. Pro forma estimates of income and expenses were too optimistic and initial operating deficit reserves were insufficient to support the projects through to sustaining occupancy.**

In other cases, primarily **projects with inexperienced developers, projects achieved a lower level of income than projected because they anticipated having double-occupancy rooms in markets** where such sharing of living space by private pay residents is not typical. In still other cases, the project could not attract sufficient private pay residents and, therefore, had to negotiate contracts with State agencies at rates that were substantially less than the private pay rates projected in underwriting. The report emphasizes that operator experience is the critical success factor in the development of Assisted Living and Board and Care facilities.

As a result of that report, FHA began post-endorsement reviews of projects insured under its Section 232 full insurance program. Those reviews and analyses are ongoing with some 22 ALF/B&C projects reviewed through June 1997.

#### **IV. ASSISTED LIVING FACILITIES**

##### **A. The ALF Product**

In the last 10 years, developers have offered Assisted Living Facilities as an alternative to nursing home care. Although studies suggest that at least fifteen percent of nursing home residents could be served by lower levels of care, ALFs are not a replacement for nursing homes. Moreover, according to an American Association of Retired Persons survey most older persons prefer to remain in their own homes. Only five percent of frail elderly persons reside in institutional settings. Nevertheless, ALFs are an important complement in growing seniors' housing industry. For success with this product, developers, lenders, and insurers must understand the unique aspects of the ALF market, appraisal, and underwriting and facility operations.

##### **B. Underwriting**

FHA review of ALF project underwriting **show that capitalization rates and expense estimates often were low resulting in over valuation of the project.** Capitalization rates often did not reflect the intensity of effort and level of risk involved with this facility type.

HUD Handbook 4600. 1 REV, dated January 1995 discusses the appraisal and feasibility analyses for ALF and B&C projects. You should review Handbook, particularly Chapter 3, Application Processing and Project Development, Chapter 7, Valuation Processing, and Chapter 13, Assisted Living Facilities for an understanding of the Department's procedures in such cases.

Prudent underwriting requires a thorough understanding of the project proposal and the product. There is no substitute for knowledge of local conditions and market preferences.

ALFs are primarily private pay facilities. In some cases, some units may be set-aside for low-income residents if bond financing requires it or the owner so designates. If so, the income estimate must reflect the set-aside of low-income units.

##### **C. Mortgagor Experience**

Inexperience of the operator was the most often specified reason for default and claim for ALF projects cited in the GAO report. The New Jersey Housing and Mortgage Finance Agency must ensure that only experienced developers and operators participate in the ALF program. Therefore, the developer or a member of the development team should have a proven track record of a minimum of three to five years in the ALF or B&C market. This experience must be in developing, marketing and operating ALFs. These facilities are clearly different from nursing homes, as the marketing focus is on hospitality coupled with health care. ALFs and B&C facilities are quite different from rental apartments and even from nursing homes, and management experience with such facilities is more important than the real estate.

The New Jersey Housing and Mortgage Finance Agency requires developers without the above experience to contract with a management company/operator that is knowledgeable about the industry and has a proven track record. (See Handbook 4600-1, REV-1, and Change 1, paragraph 13-10)

#### **D. Marketing**

Marketing to the frail elderly population requires in-depth knowledge of 1) product, 2) location, 3) price, 4) accommodations, 5) business, 6) design, and 7) community relations. The market is private pay and consumer driven. Residents have options and exercise choices regarding how they spend their money for the type of residential care facility they select, i.e., nursing home, ALF, B&C, home care, or senior retirement facility. The market study is an invaluable aid in the development of ALFs.

#### **Market Study**

The market study must show that sufficient demand exists for the proposed project with the amenities and services offered, at the appropriate price, at the size, and at that location. Since every market has different characteristics, the market study should reflect 1) types of competitors, 2) pricing, 3) age of facility, 4) referral sources, 5) track record of owner/operator (years of experience in the business), 6) name recognition and 7) expertise of the development team.

The New Jersey Housing and Mortgage Finance Agency secures an independent market analysis of current and anticipated supply/demand including data on the ages, incomes, and numbers of frail elderly population in the competitive area. The competitive area data includes a listing of the current projects and those in the pipeline (planned or under construction) and information on the wages, pricing structure, occupancy, demographics, and changes in those factors or trends. Any market study should focus on the primary market, within a 5-mile radius of the subject, with secondary market focus of up to a 10-mile radius. The market study must provide a statement of market conditions, penetration, and market position of the proposed project. As an aid to assessing the market for ALFs, see Attachment 1, Guidelines for Market Analyses.

#### **Feasibility Study**

A market study is not a substitute for a financial feasibility study. The market study is general while a feasibility study is specific to the project proposed. The feasibility study includes detailed estimates of development costs, income and expenses and consideration of expected capture rates and occupancy percentages.

The feasibility study should respect that ALFs are business ventures and not simple real estate investments. The level of business acumen required for success makes an ALF much more a health care business than a housing facility that merely provides additional services and amenities. The real estate is not what makes the project financially successful, the business enterprise that must be profitable for the project to be viable. For those providers that market special care programs, (Alzheimer's, hospice), it is important to review the business plan, proposed activities, staff ratios, room rates, architectural designs, State and local inspection reports, and referral sources.

A feasibility study determines if the proposed project can be produced and marketed at the rates reflected in the market study. The feasibility is an opinion or a report of the financial forecast and

managements assumptions. If the project is an expansion to an existing facility, the mortgagor should provide an overview of the facility (including key management staff), services occupancy, detailed list of sources and uses of funds, facility utilization, historical report on revenue and expenses, working capital funding, debt service coverage, payor sources, contracts- VA, County, State, Health Maintenance Organizations, Managed Care Organizations.

If the project is a new facility, the mortgagor should include in the business plan: size, services provided, marketing area, name and experience of the design architect and general contractor, forecast of facility utilization, revenue and expenses and key management staff and their experience with developing managing a comparable type of facility. The feasibility study must test the financial viability of the project to generate income based on stabilized occupancy and the prognosis of the market over the next five years.

## **E. Pre-Marketing**

The developer should start the pre-marketing approximately six months before the project becomes operational. The approach should expedite the lease-up period. A pre-marketing budget (typically around \$2,550 - \$3,000 per bed/unit according to industry sources) allows the mortgagor to pay rent, hire marketing staff and buy promotional services, consultants and supplies. It ensures that the mortgagor will focus on marketing from initial endorsement to project completion, operation and stabilized occupancy. The pre-marketing is critical to the initial occupancy as well as the ongoing fill-up period. The pre-marketing expense is a soft cost that should be included in the mortgage. The marketing expense is as important as the location, reputation of the developer and the project design.

The approach to pre-marketing is different for independent living units (ILU) than ALF units in cases where an ALF contains ILUs. The market study must show the additional time it may take to fill up ILUs (12-18 months.) The lead-time to get an executed admission contract for an ILU is longer than for an ALF. The lead-time to get an executed admission contract for an ILU unit (generally 12-18 months) is longer than for an ALF unit. However, the above is only meant as a guide, the best guide is the track record of the developer.

The New Jersey Housing and Mortgage Agency will look closely at the initial Operating Deficit (IOD) escrow to offset a slow lease-up period. The IOD will be critical to the success of the project during the first 10-12 months.

## **F. Design**

The proper mix of accommodations is an important factor in the success of the lease-up and occupancy. As discussed previously, some developers with nursing home experience may want to develop mostly semi-private rooms even though this type of unit has not been successful in the ALF market. Because ALF residents generally are private pay and have a choice (unlike Medicaid recipients in nursing homes), private rooms with a full bath are the standard. There may be a few semi-private rooms in some facilities where market experience supports it. However, the rationale for the semi-private rooms will be based on the desire of the developer to have some units affordable for SSI and low-income residents or for specialized markets. Alzheimer's facilities may be developed as freestanding facilities; however, the trend is to build smaller facilities comprising 16-44 beds.

While there is no typical ALF model, some developers have been successful with a prototype model used in multiple locations. HMFA may choose to develop ALFs with an affordable housing component by reducing the construction cost and partnering with local communities. If so, these facilities have less space, fewer services and different design features.

Also, developers that initially built retirement communities with ILUs may have to retrofit those units and convert them to ALFs due to "aging in place." In order to qualify for Section 232 mortgage insurance; however, the unit must be constructed to meet Federal, state and local building and fire codes, and Federal and state accessibility requirements.

The design of the ALF should be a residential vs. institutional model and give the appearance of a home-like environment. The building should be designed to maximize the needs and preferences of the residents that occupy the units. A minimum of 25 square feet (sf) of dining area and 30 sf of recreational and common space are recommended minimum standards. The unit size may vary from 150 sf (semi-private rooms) to 650 sf for a two-bedroom unit. The size will be subject to pricing, what the market will support and the cost of construction.

The design of the facility must closely match the need of the regulatory environment, providers who will operate the facilities and the residents who will occupy the units. HUD should encourage creativity in design while still adhering to enforcement codes, zoning, licensing, and local ordinances. The developer should design an ALF to meet residents' need and at the same time keep in mind that the product is market driven and the consumer has choices.

## **G. Averages**

There are some overall industry statistics and "rules of thumb" that you should be familiar with when processing ALFs. In learning about the industry in a particular area of the country, staff will undoubtedly need to fine-tune these items in view of local conditions. The following are not meant to be hard and fast rules or limits where local experience suggests otherwise. Examples to consider are:

1. According to an April 1966 survey of 120 projects by Capital Valuation Group, the average freestanding ALF project costs \$6.4 million and generates \$2.3 million in annual revenues.
2. The care in an ALF is delivered at approximately 70 percent of the cost of care in a nursing home.
3. The average operating expenses are approximately 55 percent of the cost of care.
4. The resident turnover is approximately 40 percent per year.
5. The income estimate (for qualification purposes) should take into account that the resident will spend approximately 75 percent of income on the monthly ALF costs.
6. The resident will need an income of approximately \$25,000 per year to reside in an ALF.
7. The average admission per month after the initial fill-up is three to four residents per month.



8. The typical fill up takes 10-12 months for experienced operators. The overall industry absorption rate is three net admissions per month.
9. Average construction cost is \$85 per square foot.
10. Profit margin is 35-40 percent before debt service coverage.

# **GUIDELINES FOR CONTENT AND FORMAT OF A MARKET ANALYSIS REVIEW**

## **SECTION 232 RESIDENTIAL CARE FACILITIES**

### **A. Project Description:**

1. Number of units by bedroom size or type of accommodation.
2. The estimated total monthly cost for shelter and mandatory services by size of unit or type of occupancy or accommodation.
3. The estimated total month cost for optional services of care provided on an as-needed basis.
4. The proportions of the project to be occupied by public pay/assisted tenants, e.g., SSI, and that by private pay/market rate tenants.
5. The amenities, services and care provided by this type of housing and how these relate to the physical or mental, social conditions of the prospective tenants.
6. Project location in terms of proximity to facilities and services essential to the tenants such as hospital, medical/health care facilities, social and community services, public transportation, shopping and recreational activities; and any other location considerations relevant to the market or marketability of the proposed project.

### **B. Summary of Findings and Recommendation:**

Statement of recommendation of approval or disapproval and brief summary of findings supporting the recommendation.

### **C. Definition of the Market and Sub-Market Area:**

Description of the geographic boundaries of the housing market area and an explanation for the definition, including a discussion of the primary and secondary geographic market areas and the qualitative sub-markets for the project by socioeconomic characteristics: income, household size, e.g., one-bedroom apartments, independent living units, private, semiprivate rooms, wards, etc.

1. Current Inventory: Quantitative and Qualitative Characteristics of Projects in the Market Area.
  1. Total number of units or accommodation by type or bedroom size, e.g., one-bedroom apartments, independent living units, private, semiprivate rooms, wards, etc.
  2. Total monthly charges by bedroom size or type of accommodations.

### **D. Alternative Health/Medical Care and Social Service System**

1. Description of the extent and types of alternative housing, care and services in the market.

a) Home health care, adult day care, housekeeping service, meal preparation, visiting nurses, on-call transportation services health care, and alternative providers of supportive services for the target market such as state and local government social service agencies or fraternal, social, charitable, or religious organizations.

b) The impact of these alternatives on demand for the subject project.

**E. Characteristic of Pipeline Activity:**

1. Total number of units under construction by the total monthly costs by bedroom size or type of accommodation, and the services or amenities planned (mandatory or fee for service).
2. Total number of units in the planning stages with permits or firm financial commitments. It is essential to have the most up-to-date and comprehensive information possible on the pipeline so that disagreements of supply volume with lenders and sponsors may be accurately discussed and resolved.

**F. Demand Estimate and Analysis**

1. The market analysis is based on an estimate of annual demand for the type of residential care. The demand estimate should show the number of unit or accommodations by type and the total monthly charges.
2. An analysis which reconciles the proposed project with the demand estimate, taking into consideration the forecast household and population growth of the target group(s), the current vacancy situation, and the supply in the pipeline.
3. The demand estimate should reflect "effective demand" and should be based on the numbers of households with sufficient incomes and need for the type of shelter and care that could reasonably be expected to be captured by the market during the forecast period.
4. Typical types of services and amenities offered, whether these are mandatory or optional fees for services, and whether services are provided by the facility (directly or by contract) or through a third-party arrangement (tenant and care provider).
5. A discussion of the types of projects and other housing option comparable to and competitive with the subject project; both in terms of the type of ownership/financing and tenant admission, e.g., private or public financed, extent of private pay or public pay (Medicare, Medicaid and SSI patients).
6. Condition of inventory with consideration of the proportion that may be substandard or obsolete in terms of physical plant, services, amenities, etc. This is particularly important when the proposal involves skilled nursing care or project with a combination of levels of care revolving around a "medical model."
7. Characteristic of the current tenants in terms of socio-economic and psycho-physiological conditions, e.g., age, income, sex, and limitations in activities o daily

living, cognitive impairments, disabilities, etc.

8. Absorption experience of recently completed projects on a units per month basis, discussing the level and extent of any pre-sale or pre-marketing efforts.
9. Extent of turnover and size of waiting lists in existing projects.
10. Current occupancy in comparable and competitive projects and in the market area for the type(s) of product, including a discussion of reasons for any vacancy or absorption problems in the market.
11. Current total monthly charges for comparable and competitive product, with consideration of typical amenities and service package.
12. Extent of concessions or similar incentives in existing projects or projects in initial rent-up.
13. A descriptive analysis of the demand estimate, which addresses the primary determinants including:
  - a) Current and projected population of the target group(s) by age cohort and the proportion of the market each group comprises.
  - b) Current and projected estimates of the primary group to be served by social, physiological, psychological characteristics, i.e., the extent and type of limitation in activities of daily living or cognitive impairment/disability.
  - c) Current income level/band of income of prospective households comprising demand, including cost/rent to income ratio(s) assumed in the analysis.

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